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SUBJECT: TURKISH CYPRIOT ECONOMY ENJOYING DOUBLE-DIGIT
GROWTH

(U) This cable is sensitive but unclassified. Please
protect accordingly.

1. (SBU) Summary: Over the past three years the service-based Turkish Cypriot economy has experienced double-digit annual economic growth -- an estimated 10.6 percent in 2005, 15.4 percent in 2004 and 11.4 percent in 2003, according to Turkish Cypriot statistics. This growth has been fuelled by the relative stability of the Turkish Lira, a large construction boom, the expansion of Turkish Cypriot universities -- which cater to Turkish and other international students -- and the employment of roughly five thousand Turkish Cypriots in the Greek Cypriot south where wages are significantly higher. As a result, the income gap between Turkish Cypriot and Greek Cypriots has narrowed (per capita GDP is now estimated as USD 10,200 in the north and USD 22,506 in the south), which should improve the workability and alleviate the financial costs to the Greek Cypriot community of any future settlement. The construction boom, however, which has often involved the development and sale of property owned by Greek Cypriots displaced in 1974, has further muddled the already cloudy property issue, complicating efforts to find any settlement acceptable to both sides.

2. (SBU) Tax avoidance is common and as much as 60 percent of the north's economic activity remains unregistered. Despite efforts to obtain more political autonomy from Turkey, the Turkish Cypriot community continues to remain dependent on the GoT to finance its bloated public sector and most major infrastructure projects. Growth is forecast to slow to seven percent in 2006 and could slow further should the Turkish Lira continue to slide, oil prices continue to rise, or Greek Cypriot legal challenges against British owners of Greek Cypriot property prove successful. End Summary.

Private Consumption Drives Double Digit Growth

3. (SBU) The self-proclaimed "Turkish Republic of Northern Cyprus" ("TRNC"), is only recognized by Turkey and controls about one-third of the island's area and around a fifth of the population (264,172 people were physically present in the north on April 30, 2006, according to preliminary results from last month's census). The New Turkish Lira (YTL) is the main currency, although British and Cyprus Pounds are widely used. The economy is largely service-based and heavily dependent on imports. Turkish Cypriots produce very little and export even less. Businesses tend

to be small and family-based.

¶4. (SBU) Over the past three years, the Turkish Cypriot economy has expanded rapidly, driven largely by strong growth in private consumption. After contracting by 5.4 percent in 2001 in the wake of the Turkish financial crisis, real GDP in the Turkish Cypriot community increased by 6.9 percent in 2002, 11.4 percent in 2003, 15.4 percent in 2004 and an estimated 10.6 percent in 2005, according to the Turkish Cypriot "State Planning Office (SPO)." Key to this has been the relative stability of the Turkish lira, which has led to significant reductions in interest rates and increased business and consumer confidence. Other significant sources of growth have been a boom in construction and property sales (often to foreigners -- mainly Brits), the employment of several thousand Turkish Cypriots in the Greek Cypriot south, and the rapid expansion of the universities catering primarily to mainland Turkish youth. (Note: Turkish Cypriot statistics should be treated as indicative rather than exact. Statistical practices do not meet international standards and training of employees in the SPO is limited.)

Around Five Thousand Turkish Cypriots Work in the South

¶5. (SBU) Estimates of the number of Turkish Cypriots employed in the south -- mainly in construction and tourism -- range from 4,000 to 10,000. Given that GoC statistics show an average of less than 6,000 Turkish Cypriots crossing the Green Line per day, the true figure is probably closer to four than to ten. According to a recent EU report, the increased income this has generated had added an estimated 100 million Euros to the north's GDP (or around 9 percent of GDP alone).

¶6. (SBU) The exodus of Turkish Cypriot workers to the south has also created labor shortages in the north (especially in construction), which are often filled by importing cheap labor from Turkey (Turks are not allowed to cross the Green Line). In some sectors, where qualified Turkish labor is also scarce, it has pushed up Turkish Cypriot wages, increasing Turkish Cypriot discretionary spending but also increasing business costs.

Education: Catering to the Turkish Masses

¶7. (SBU) Another source of the rapid economic growth is the six universities in the north, which teach in English and are rapidly increasing their intake of foreign students. During the 2005-2006 school year, the six universities enrolled 39,383 students (up from 35,000 the previous year), of which only 9,877 were Turkish Cypriot. Almost 27,000 were from Turkey and the rest were mainly from Iran, Africa, and the Middle East. Turkish Cypriot "Economy Minister" Dervis Deniz described the economic impact of the students, who pay tuition, room and board, as equivalent to 1.2 million tourists. The universities are accredited by the Turkish authorities and tend to attract Turkish students, who are unable to get into any university on the mainland. Were the Turkish education authorities to withdraw their accreditation, something which appears unlikely in the near term, this industry would collapse.

Construction: Fueling Growth but Muddying Property Issue

¶8. (SBU) The construction sector, and ancillary businesses, have boomed in the north since 2002, and accounted for 35 percent of the growth in 2004 alone, according to "Finance Minister" Ahmet Uzun. The increase in property prices has also caused a wealth effect, contributing to the growth of private consumption. There were over 3,000 applications for new building permits in each of the past three years. Greek Cypriot legal challenges combined with rising prices appear to have slowed down the tourist villa market aimed primarily at the foreign (mostly UK) buyer. Imports of construction materials, however, have not declined and new construction for the domestic market and in hotels and universities has, for now, filled the void. Note: As much as 85 percent of

the land in the north is claimed by private Greek Cypriots displaced in 1974 (around 60 percent) or the government (an additional 25 percent). End note.

¶9. (SBU) Nevertheless, most observers believe this boom may have reached its peak and is, in any case, unsustainable in the mid-term. The construction has rapidly outpaced the north's limited infrastructure, aggravating traffic, straining waste facilities, and contributing to persistent shortages of water and electricity. An upcoming decision by a UK judge whether to enforce a Greek Cypriot court order against a British couple living on Greek Cypriot land also has the potential to crash the market. Much of the construction has occurred on Greek Cypriot property, which will make any future reunification of the island significantly more complicated.

Tourism: Big Plans for Future but Stagnant in 2006

¶10. (SBU) With some of the best beaches and historic sites in Cyprus, tourism in the north remains an economically-important but largely untapped sector. Efforts to attract new tourists are often stymied by the Greek Cypriot Tourism Organization (CTO), which discourages (through the use of legal threats and financial incentives) international tourist operators from sending tourists to the north, where the vast majority of hotels and restaurants are located on Greek Cypriot property. While there are many flights from the UK to the north (and a few from elsewhere in Europe), all must touch down in Turkey in route (due to GoC's insistence as the sovereign government that Ercan is an illegal airport), increasing the cost and duration of travel. Efforts to bring tourists through the airports in the south have also proven difficult due to problems getting seats, unpredictable delays at the Green Line, and restrictions on Turkish Cypriot buses operating in the south.

¶11. (SBU) Nevertheless, in 2005, the Turkish Cypriot community welcomed 652,000 tourists up from 599,000 in 2004 (of which 488,000 came from Turkey and 90,000 from the UK),

compared to roughly 2.4 million tourists in the south. At the end of 2005, Turkish Cypriot hotels had a bed capacity of around 13,000 and a year-round occupancy rate of 42.8 percent. Plans are in place for the construction of an additional 30 hotels. The Turkish Cypriot authorities plan to increase bed capacity to 30,000 by the end of 2007, eventually rising to 45,000 (compared to around 100,000 in the south). The cornerstone project is a multi-hotel, 9,000-bed project at Bafra in the Karpas, which aims at attracting major international tour operators. Another 10,000 beds are planned for a major development along the coast north of Morphou.

¶12. (SBU) While there are big plans for the future, actual tourist arrivals are not expected to increase in 2006. According to the association of Turkish Cypriot tour operators, bookings are down 30 percent so far this year, mainly due to fears sparked by the isolated avian influenza outbreak in January and lower prices being offered in Turkey. Even the usually optimistic "Economy Minister" Deniz concedes that the overall number of tourism arrivals is unlikely to exceed last year's number.

Bloated Public Sector Financed by Turkish Largess

¶13. (SBU) The Turkish Cypriot authorities continue to be dependent on large scale Turkish transfers. According to "Finance Minister" Uzun as much as a third of the "TRNC's" USD 1.2 billion annual budget is financed by Turkey. Turkey also regularly obligates over an additional USD 100 million a year for infrastructure projects, part of which often remains unspent due to the Turkish Cypriot authorities' failure to identify promising projects. In recent years, the Turks have financed the construction of highways and new university buildings as well as the renovation of Ercan airport. Contracts, however, are generally awarded to

Turkish (and not Turkish Cypriot) firms, diminishing their impact on the local economy. The Turkish Development Bank has also awarded USD 150 million in low-interest loans (again primarily to Turks) to finance construction of hotels. According to documents released by the "Turkish Embassy," Turkey budgeted USD 531 million for the "TRNC" in 2004 and USD 581 million in 2005.

¶14. (SBU) Turkey's largess is critical to plugging the large holes left in the Turkish Cypriot budget due to the bloated public sector -- the result of years of make-work schemes designed to keep young Turkish Cypriots from leaving the island -- and rampant tax avoidance practiced by most local firms. Efforts to cut jobs and stem wage increases, often a nominal requirement for further Turkish aid, have regularly failed due to opposition from the powerful Turkish Cypriot unions. Most Turkish Cypriot firms keep two sets of books and most transactions take place using cash. According to Uzun, 60 percent of all business transactions are unrecorded.

Trading with the World Through Turkish Cypriot Ports

¶15. (SBU) While tourism and education are the Turkish Cypriot community's major exports, the north continues to be heavily dependent on the import of goods. Turkish Cypriots imported almost USD 1.2 billion in goods in 2005 while exporting only 67.9 million, according to the Turkish Cypriot "State Planning Organization." Turkey was the north's largest trading partner accounting for 65 percent of the north's imports of goods and 50 percent of its exports. Despite a 1993 European Court of Justice decision that effectively prevents EU countries from giving Turkish Cypriot goods preferential treatment, the EU still accounts for 22 percent of imports and 27 percent of exports. In 2005, Turkish Cypriots imported USD 8.2 million worth of goods from the U.S. (e.g. grains, tobacco products, cars etc.) while exporting less than USD 50,000 (textiles). Official Turkish Cypriot trade with the Greek Cypriot community is minimal, totaling a little over USD 2 million in sales and around USD 300,000 in purchases in 2005. Informal, unregistered, trade is thought to have been several times higher.

¶16. (SBU) Over 99.9 percent of all goods imported or exported by the Turkish Cypriot community flow through Turkish Cypriot ports, although most is transshipped through Turkey. Almost all sea traffic is conducted by a relatively

small group of cargo ships that ply the Mersin-Famagusta route or an even smaller group of truck ferries that sail between Mersin and the small tourist port of Kyrenia. While transshipment through Turkey on Turkish- or Turkish Cypriot-flagged ships is the norm, there are exceptions. Embassy officers have observed North Korean and Russian flagged vessels in Famagusta. Freight forwarders report that some ships carrying citrus regularly sail directly to and from Ukraine and Russia (carrying grain on the way back.) There are also occasional, unconfirmed, reports of ships sailing directly to the north from western European ports, but these appear to be few and far between.

Slower Growth Expected in 2006

¶17. (SBU) Given uncertainties over the construction boom and number of tourist arrivals, most observers expect slower growth in 2006. The Turkish Cypriot "State Planning Organization" has forecast growth of around 7 percent. Other factors that could lead to even slower growth (or even a recession) include an outbreak of AI, continued increases in oil prices, and a UK decision against British property owners in the north which could collapse the property market.

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